

WHAT IS A SECURITY IN THE CROWDFUNDING ERA?

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I. INTRODUCTION

Financial interests in business enterprises are becoming more complex. No longer necessarily content to offer, sell, buy or hold traditional debt and equity interests, business enterprises and their funders continue to explore ways of meeting their respective and collective needs with innovative new financial interests, instruments and offerings.¹ Over the years, the lines between securities and financial products regulated under commodities, banking and insurance law have become blurred. Moreover, with the advent of the crowdfunding era, financial interests in business enterprises may look less like investment instruments commonly known as common stock or debentures, and more like loans, gambling bets, rights to consumable products or services or charitable or other nonprofit donations.²

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¹ For purposes of this essay, the term “interest,” when used in relation to a business enterprise (firm or project), references the accumulated set of rights or other benefits, responsibilities or other obligations and other terms and provisions that the funder of a business enterprise acquires in return for the funds transferred to the business enterprise. These terms and provisions may be embodied in one or a series of documents. The term “instrument” labels the interest as documented, e.g., common stock, preferred stock, debenture, note, etc. An “offering” is a transaction in which instruments are offered and sold. Financial interests and instruments are those that include a pecuniary element.

² Other scholars have noted similarities and differences between and among these financial and financial-related interests. *See, e.g.,* Theresa A. Gabaldon, *John Law, with a Tulip, in the South Seas: Gambling and the Regulation of Euphoric Market Transactions*, 26 IOWA J. CORP. L. 225, 229 (2001) (addressing “the intuition that many modern financial market transactions have been strongly reminiscent of gambling”); Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 713 (2006) (“Securities regulation is not a consumer protection law. Rather, scholarly analysis of securities regulation must proceed on the assumption that the ultimate goal of securities regulation is to attain efficient financial markets and thereby improve the allocation of resources in the economy.”); Nancy J. Knauer, *The Paradox of Corporate Giving: Tax Expenditures, the Nature of the Corporation, and the Social Construction of*

Innovations in financial interests and instruments raise a number of important questions about regulatory authority and interpretation. How do we classify the instruments that represent complex or hybrid financial interests in business enterprises? What area of regulation should apply to them? Why? What do the answers to those questions tell us, if anything, about the current (and possible future) structure and function of domestic and international financial regulation? This essay preliminarily explores the features of certain financial instruments in an effort to begin to answer these questions by focusing on what a security—a statutory and regulatory category including specific financial instruments—is and should be under federal securities law.

Specifically, this essay uses the growth of crowdfunding before the enactment of the Jumpstart Our Business Startups Act³ (JOBS Act) to reflect on the instruments that are considered securities under federal law. Crowdfunding describes a variety of different models for offering and selling financial instruments over the Internet. The interests represented by these instruments are at least as varied as the offerings in which they are sold, and this taxonomy of interests and instruments only becomes more complex in light of the regulatory facilitation of crowdfunded securities offerings through Title III of the JOBS Act, known as the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 (CROWDFUND Act).⁴ A closer look at innovations in interests, instruments and offerings in the crowdfunding era preceding this regulatory change offers a basis for comparisons and contrasts that raises questions about the categorization of instruments regulated as securities. These and other questions are important to a rethinking of the structure of financial and financially related regulation in and outside the realm of U.S. securities law.

The thought experiment conducted through this essay proceeds in four subsequent parts. First, this essay describes, in a general sense, the current system of securities regulation and the securities that are the subject of that regulatory system. Second, this essay describes and makes relevant observations about crowdfunding—crowdfunded offerings and crowdfunded instruments—in the era prior to the full implementation of the CROWDFUND Act (which is expected to occur in early 2013). Based on these first two parts, this essay continues by contextualizing crowdfunded instruments in the greater schemes of regulation. Specifically, this part of

Charity, 44 DEPAUL L. REV. 1, 66 n.366 (1994) (“Many states regulate the solicitation of charitable contributions as a form of consumer protection for unwitting donors and require charities and those soliciting for them to register with a central agency or otherwise comply with the disclosure requirements.”).

³ Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (to be codified in scattered sections of 15 U.S.C.).

⁴ See *id.* §§ 301–05.

this essay addresses, from the standpoint of early crowdfunding interests and instruments, the attributes of securities regulation and securities that may make them, at least in theory, distinct from other financial regulatory schemes and financial instruments. This part of this essay identifies potential distinctions and relates them to broader conversations about financial regulation and instruments, many of which are occurring at the opposite end of the financial regulation spectrum—the end of the spectrum that governs commodities, commercial loans and insurance products. This essay ends with a brief conclusion.

II. U.S. FEDERAL SECURITIES REGULATION AND SECURITIES

The federal system of securities regulation in the United States, a product of the federalization movement of the 1930s, has been described and theorized in numerous works over the years. The description and theorization of financial instruments classified as securities under that system is similarly established and rich. This part synthesizes those bodies of literature as a basis for the further observations and analysis that follow.

A. *Securities Regulation*

The federal system of securities regulation effectuates policy through various different regulatory tools that both inform and are informed by theoretical principles. Accordingly, it is important that we understand the policy and theory on which the current system of U.S. securities regulation is founded and that we understand the attributes of the resulting system of securities regulation currently operating at the federal level in the United States.

1. *Policy*

Although variously stated, the key policies underlying U.S. securities regulation are the protection of investors and the maintenance of the integrity of the national securities markets, with the overall objective of enhancing prospects for capital formation to sustain business activity and growth.⁵ I purposely articulate the policy objectives this way—with

⁵ See, e.g., Securities Act of 1933 § 2(b), 15 U.S.C. § 77b(b) (2006) (requiring the SEC, when it is “engaged in rulemaking and . . . required to consider or determine whether an action is necessary or appropriate in the public interest,” to “also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.”); Securities Exchange Act of 1934 § 3(f), 15 U.S.C. § 78c(f) (2006) (same); Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 941 (1998) (“One of the most cited and intuitive goals of the securities laws is the protection of investors.”); Tamar Frankel, *The Internet*,

investor and market protections contextualized by reference to capital formation—but it is far from clear that my view on the arrangement of these policies in relation to each other is the prevailing interpretation.⁶ An alternative formulation, for example, does not directly address market integrity and prioritizes capital formation quite differently.

Securities regulation is generally advanced under the rubric of “investor confidence” or “investor protection,” as is the SEC’s statutory mandate. The goals of economic efficiency and capital formation, where they appear in the federal securities laws, serve as decidedly secondary considerations. Moreover, the implementation of investor protection goals may appear inconsistent across unrelated rulemaking exercises.⁷

Securities Regulation, and Theory of Law, 73 CHI.-KENT L. REV. 1319, 1325 n.17 (1998) (“[M]any . . . securities acts’ regulations, are based on two policies: protecting investors, to maintain their confidence in the markets’ integrity, and the encouragement of capital formation.”); Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 804 n.179 (2006) (“Investor protection is a means to an end—the goal of helping markets by solidifying investor trust in them so that they may thrive.”); Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT’L L.J. 31, 45 (2007) (“[T]he goals of protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation rephrase and synthesize the objectives of securities regulation [are] contained within the Exchange Act’s preamble.”).

⁶ I am not alone in my view that capital formation is a unifying principle:

Although the primary goal of securities regulation is frequently articulated as investor protection, this understanding is too simplistic. Capital formation is at the heart of the capitalist system. The reason securities regulation became a matter of federal concern is that there was a need to increase investor confidence in order to generate capital formation in the 1930s. There was also a need to assure against systemic collapses caused by excessive stock market speculation leading to the bursting of the stock market bubble in 1929 and the bankruptcy of numerous financial institutions. State securities regulation and SRO regulation had proved inadequate in performing this task, which was national in scope.

Roberta S. Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 BROOK. J. INT’L L. 495, 545 (2003).

⁷ Onnig H. Dombalagian, *Licensing the Word on the Street: The SEC’s Role in Regulating Information*, 55 BUFF. L. REV. 1, 33–34 (2007) (footnotes omitted).

Regardless of the interrelationship among the three articulated policy interests, however, it is safe to say that U.S. securities regulation exists to protect investors, markets and capital formation.⁸

The notion of investor protection is commonly cited, yet rarely defined. It is not apparent what investor protection means in different contexts. Assuming we can identify what an investor is (and that is not as simple as it appears), it seems appropriate to ask from what or from whom investors need protection and how that protection might be provided.⁹ Are we afraid that investors lack leverage in seeking information or negotiating terms? Are we concerned about bad actors engaging in activities that deceive market participants or artificially affect investment markets? Are we worried that certain types of transactions or certain market players are inherently harmful to investors or markets? Thinking somewhat more deeply, we might also ask what rules apply when the interests of one investor negatively impact those of another or when the interests in protecting investors, markets and capital formation otherwise collide. Moreover, different types of investors may need different protections in different circumstances.¹⁰

The maintenance of market integrity is also an elusive objective. What does it mean to maintain (protect, promote, etc.) the integrity of a market? This question is founded on the non-obvious foundational concept of market integrity. May we conclude that a market has integrity if market activity is sustained over a prolonged period of time? Must we establish that a market is efficient, competitive or free (at least substantially free) from fraud in order to characterize it as having integrity? It is obvious that certain

⁸ See generally *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/about/whatwedo.shtml> (last visited Oct. 30, 2012).

⁹ One scholar offers the following basic answers:

Investor protection is a hallmark goal of federal securities law and an animating principle of the SEC. Investor protection means protecting investors from economic losses stemming from fraud and more subtle forms of opportunism by issuers, traders, and other market participants. The legislative history of the Securities Act and the Exchange Act demonstrates that Congress was concerned with ordinary investors being subjected to fraud, inadequate disclosure, and manipulation of stock prices.

Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 BERKELEY BUS. L.J. 240, 285 (2009) (footnotes omitted).

¹⁰ See Paula J. Dalley, *The Use and Misuse of Disclosure as a Regulatory System*, 34 FLA. ST. U. L. REV. 1089, 1095 (2007) (“[R]egulation of different kinds of investments may be directed at different kinds of investors. Hedge fund investors, for example, tend to be wealthy and sophisticated, while mutual fund investors tend to be middle class and unsophisticated.”).

market activities are unfair or dishonest (e.g., manipulating trading volume or prices so that one investor can buy low or sell high, as occurs in a “pump and dump” scheme).¹¹ However, some activities that may have undesirable effects on securities markets do not constitute unfair or dishonest practices (e.g., acquiring and using material, nonpublic information in a manner that creates advantages for certain market participants but may not be deceptive, manipulative, fraudulent or otherwise unjust).

Finally, the policy goal of promoting capital formation is somewhat vague. Capital can take many forms. The ostensible focus of the securities regulation system is financial capital. It is implausible that Congress intended to encourage the formation of an infinite amount of financial capital for all issuers under all circumstances. The concept of capital formation typically is broadly construed in the securities regulation context,¹² and its use as a policy objective has supported different types of regulation at different times. Most recently, Congress turned its ostensible

¹¹ Pump-and-dump schemes are aptly named.

In a “pump and dump” scheme, the perpetrator generally touts (“pumps”) a stock by making baseless projections about its future share price and/or unjustified forecasts about the company’s future earnings. To enhance the legitimacy of their claims, the perpetrator often alludes to fictitious contracts or non-existent merger talks. With the exponential growth in the number of people using the internet over the past decade, the World Wide Web has become the most popular medium for the perpetrator to communicate with the investing public. As the market digests the false and misleading information, the share price of the targeted company usually moves dramatically in the direction intended by the scheme’s architect. When the perpetrator believes that the market has reached the ceiling (or floor) based on the false and misleading information that he supplied, the perpetrator sells (“dumps”) their [sic] entire position and realizes a substantial gain.

David B. Kramer, *The Way It Is and the Way It Should Be: Liability Under § 10(b) of the Exchange Act and Rule 10b-5 Thereunder for Making False and Misleading Statements as Part of a Scheme to “Pump and Dump” a Stock*, 13 U. MIAMI BUS. L. REV. 243, 245 (2005) (footnotes omitted); see also Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 762 (2005) (“Regulators have no problem viewing pump-and-dump schemes as manipulations of the market Presumably, these schemes are undesirable because they create inefficient markets in which investors overpay for stock and then lose money once the hyping of the stock ends and the insiders dump their shares.”).

¹² See Marc I. Steinburg & Emmanuel U. Obi, *Examining the Pipeline: A Contemporary Assessment of Private Investments in Public Equity (“PIPEs”)*, 11 U. PA. J. BUS. L. 1, 1 (2008) (defining capital formation as “a company’s ability to effectively and efficiently raise capital for various needs at different junctures in its life”).

attention to small business capital formation in its passage of the JOBS Act.¹³ But within the past ten years or so, Congress and the SEC also have been attentive to assisting the capital formation efforts of larger, public issuers.¹⁴

Thus, the policy considerations underlying U.S. securities regulation are broad-based and give rise to many good, unanswered questions. Moreover, these policy objectives may compete, rather than harmonize, in certain circumstances.¹⁵ The financial crisis, the rise of crowdfunding and other recent social, economic and political events and forces challenge the notion that we have properly struck a balance among these considerations, despite our relatively mature system of regulation. These forces are putting pressure on the need for clearer answers to longstanding and emergent policy-oriented questions.

2. *Theory*

A number of important bodies of theoretical knowledge help describe and predict the way securities markets function and the way the participants in those markets behave. These include efficient market theory, behavioral finance and portfolio theory. Principles gleaned from these (and other) theories inform or may inform the construction and modification of structures and rules incorporated into the U.S. system of securities regulation. I describe each of these theories in brief here.

The three different articulations of the efficient capital markets hypothesis (ECMH, also known more generally as the efficient market hypothesis)—strong, semi-strong and weak—each posit different ways in which market-based, public and non-public information affects market pricing. In general, the ECMH assumes that, in an efficient market,

¹³ See *supra* note 3 and accompanying text. The JOBS Act is self-described as an initiative “[t]o increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.” Jumpstart Our Business Startups Act pmb., Pub. L. No. 112-106, 126 Stat. 306 (2012) (to be codified in scattered sections of 15 U.S.C.).

¹⁴ See, e.g., Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28 and 29 U.S.C.); Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, Investment Company Act Release No. 26,993, 70 Fed. Reg. 44,722 (Aug. 3, 2005) (codified in scattered sections of 17 C.F.R.).

¹⁵ Dalley, *supra* note 10, at 1095 (noting that investor protection and market enhancement goals of U.S. securities regulation “are not the same and may not even be purely complementary. Market efficiency may be enhanced, for example, when investors’ mistakes are punished by losses and investors have the opportunity to learn to invest more rationally or to stay out of the market and leave the decision-making to experts.”).

information is reflected in market pricing.¹⁶ Efficient markets depend on market participants behaving in predictable, rational, utility-maximizing ways in response to information.¹⁷ The dominant articulation of the ECMH as an explanatory theory for the disclosure aspects of the current U.S. securities regulation system is the semi-strong version of the ECMH, which holds that all publicly available information is inculcated in the market pricing of securities.¹⁸ Accordingly, those who have that public information cannot “beat the market.” In other words, informed traders should have no advantage in market transactions based on their possession of public information.¹⁹ The semi-strong version of the ECMH explains and predicts many, but not all, of the movements in and attributes of securities markets in the United States.

Behavioral finance, a discipline at the intersection of behavioral and cognitive psychology and traditional economic and financial theory, fills some gaps left by the ECMH by explaining market movements and

¹⁶ See *In re LTV Sec. Litig.*, 88 F.R.D. 134, 144 (N.D. Tex. 1980); see also Shannon Rose Selden, *(Self-)Policing the Market: Congress's Flawed Approach to Securities Law Reform*, 33 J. LEGIS. 57, 65 (2006).

¹⁷ See Richard A. Posner, *Are American CEOs Overpaid, and If So, What If Anything Should Be Done About It?*, 58 DUKE L.J. 1013, 1036 (2009) (“The efficient market theory assumes that securities markets operate as if the traders in them were rational”); see also Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1035 (2000) (“Neoclassical economics is premised on rational choice theory, which posits an autonomous individual who makes rational choices that maximize his satisfactions.”); Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 858 (1992) (“The conventional economic model postulates that rational decision-makers search for the option having the largest subjective expected utility, determined by reference to probabilities derived from the available information set.”).

¹⁸ See Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333, 359 n.111 (2006) (“Under the . . . semi-strong version of the efficient market hypothesis, the market price of broadly-traded public securities reflect[s] all publicly available information on the securities because the actions of investment analysts and institutional investors will send signals to the rest of the market regarding the value of the shares.”). See generally Eugene F. Fama, *Efficient Capital Markets II*, 46 J. FIN. 1575 (1991); Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970) (identifying three forms of market efficiency—weak, semi-strong and strong—that have since become iconic in the literature); Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. ECON. PERSP. 59 (2003) (surveying, analyzing and explaining market efficiency and inefficiency using statistical analysis and specific examples).

¹⁹ Cross & Prentice, *supra* note 18, at 333 n.111 (“Lay investors need not be personally conversant with the publicly available information to understand what a fair market price for a security is, so long as the professional investors have not been misled.”).

attributes not well accounted for by the traditional, neoclassical economic analysis from which the ECMH is derived.²⁰

Economists using innovative and interdisciplinary approaches have become increasingly convinced that orthodox economic theory cannot adequately explain market and investor behavior. They challenge standard economic views Investors, they contend, are influenced by many factors and markets are rarely efficient. Offering a holistic criticism (although not a coherent alternative model), economists have identified critical irrationalities and inefficiencies in market and investor behavior.²¹

The operation of these identifiable irrationalities and inefficiencies is inconsistent with the rational investor behavior model embodied in the ECMH. The systematic (rather than individualized or episodic) presence of biases that run counter to rational decision-making help to explain observations about market activity that are not explained by the ECMH and may result in better predictive capacity.²²

Portfolio theory, used by investors and investment intermediaries to construct optimal blends of investment assets, identifies the source and effects of risk in investment holdings. The theory generally

²⁰ Unlike the ECMH, behavioral finance does not alone explain or predict the market for securities in a comprehensive way. See Bainbridge, *supra* note 17, at 1035 (“To date, behavioral economics has not (and may not ever) develop a single theory that explains or predicts the full range of human behavior, as rational choice theory claims to do. Instead, it offers a pragmatic collection of ‘situation-specific mini-theories useful in the analysis of discrete legal problems.’” (footnotes omitted)).

²¹ Selden, *supra* note 16, at 66; see also Brett H. McDonnell, *Getting Stuck Between Bottom and Top: State Competition for Corporate Charters in the Presence of Network Effects*, 31 HOFSTRA L. REV. 681, 693–94 (2003) (“[M]any corporate finance and law scholars have begun to call into question the semi-strong version of the efficient market hypothesis. Advances in both behavioral finance theory and in empirical testing have suggested that securities markets may be more flawed than previously believed.”).

²² Professor Steve Bainbridge further explains:

Standard economic analysis recognizes that individual decisionmakers may depart from rationality, but assumes that such departures come out in the wash—they cancel each other out so that the average or equilibrium behavior of large groups will be consistent with rational choice. By asserting that decisionmakers exhibit systematic biases, behavioral economics denies that claim.

Bainbridge, *supra* note 17, at 1035 n.54.

proceeds from the premise that individual stocks in a portfolio are subject to risks that are negatively correlated, that is, an event that will cause the rise in the price of one stock will tend to depress the price of another. For example, high oil prices may be good for oil companies but bad for airlines. The object of diversification is to minimize risks that are specific to a particular company, or perhaps a segment of an industry. From the perspective of modern portfolio theory, firm-specific risk represents an impermissible speculation that can be offset, or eliminated, by combining stocks subject to distinct risks without reducing the average expected return. A skillfully diversified portfolio is still subject to market-wide risks caused by vicissitudes of the economy, but these market risks can be set at a desired level by investing in different categories of assets with different risks and probable returns. Thus, the investment of a segment of a portfolio in cash or treasury bonds will lower portfolio risk as well as the expected return.²³

While not descriptive of all investment behavior, these principal dictates of modern portfolio theory (that investors should diversify their equity holdings in order to decrease firm-specific risk and diversify their investment assets across different asset classes in order to decrease systemic risk) are the backbone of a rational, reasonable and wise investment strategy.²⁴ However, U.S. securities regulation does not always assume that investors are diversified and, accordingly, does not necessarily focus on protecting diversified investors. Rather, the prevailing touchstone for investor protection under federal securities law liability provisions is the “reasonable investor,” a term that evades simple definition.²⁵

²³ Michael E. Murphy, *Pension Plans and the Prospects of Corporate Self-Regulation*, 5 DEPAUL BUS. & COM. L.J. 503, 508 (2007). See generally Edwin J. Elton & Martin J. Gruber, *Modern Portfolio Theory, 1950 to Date*, 21 J. BANKING & FIN. 1743 (1997) (reviewing, analyzing and applying portfolio theory as originated by Markowitz, *infra*); Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952) (outlining the basis for modern portfolio theory).

²⁴ See Dalley, *supra* note 10, at 1095 (“Modern portfolio theory suggests that any rational investor will hold a well-diversified mix of common stocks and other investments.”); see also Murphy, *supra* note 23, at 508 (“The analysis of modern portfolio theory strongly supports the principle that diversification is a mandatory practice of prudent investing.”).

²⁵ The federal securities laws include a number of key liability provisions that require the establishment of a material misstatement or an omission of a material fact. See, e.g., Securities Act of 1933 §§ 11, 12(a)(2), 17(a), 15 U.S.C. §§ 77k, 77l(a)(2), 77q(a) (2006), amended by Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012); 17 C.F.R. § 240.10b-5 (2012) (Rule 10b-5

These three theories focus narrowly on investors in securities and securities markets. Accordingly, efforts to effectuate investor and market protection policies through legislation and agency rulemaking are often rooted in elements of or principles derived from these theories. As a result, these theories, together with the policies described in Part II.A.1, help explain and define key attributes of the basic structure and operation of federal securities regulation in the United States.

3. Resulting Regulatory System

The U.S. securities regulation regime uses three principal kinds of rules to achieve its policy objectives. These rules—the tools in our securities regulation toolbox—are mandatory disclosure, fraud prevention and substantive regulation. They operate in connection with offers, purchases and sales of (as well as other financial transactions affecting) securities and also in connection with the exercise by security holders of voting and consent (i.e. governance) rights. The first two tools—mandatory disclosure and fraud prevention—are somewhat self-explanatory and well-trod in the literature.²⁶ Both focus to a great extent on transparency and the avoidance or correction of informational asymmetries. The third—a more heavy-handed, authoritarian approach—focuses on regulating the terms of and participants in financial and governance transactions relating to securities

under the Securities Exchange Act of 1934, as amended). The reasonable investor is the reference point for determining the materiality of misstatements and omissions under these provisions. *See, e.g.,* *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (adopting for use under Rule 10b-5 two alternative formulations of a materiality standard first adopted by the Court in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976)); *see also* *Litwin v. Blackstone Grp., LP*, 634 F.3d 706, 717–18 (2d Cir. 2011) (applying the same legal standard in a case involving sections 11 and 12(a)(2) of the 1933 Act). *See generally* Joan MacLeod Heminway, *Female Investors and Securities Fraud: Is the Reasonable Investor a Woman?*, 15 WM. & MARY J. WOMEN & L. 291, 296–309 (2009) (identifying and describing various legal conceptions of the reasonable investor).

²⁶ *See, e.g.,* Christopher M. Bruner, *Managing Corporate Federalism: The Least-Bad Approach to the Shareholder Bylaw Debate*, 36 DEL. J. CORP. L. 1, 43 (2011) (“Congress’ principal intent in enacting the securities laws was investor protection (primarily through mandatory disclosure coupled with anti-fraud rules)”); *see also* Peter H. Huang, *Herd Behavior in Designer Genes*, 34 WAKE FOREST L. REV. 639, 662 (1999) (“United States federal securities law is based on a philosophy of mandatory disclosure rules and anti-fraud regulations.”); Frank Partnoy, *Don’t Blink: Snap Decisions and Securities Regulation*, 77 BROOK. L. REV. 151, 163 (2011) (referring to “mandatory disclosure and ex post anti-fraud enforcement” as “the twin pillars of the 1930s securities laws”).

and in the securities markets.²⁷ A brief description of each of these regulatory methods follows.

The protection of investors and markets and the encouragement of capital-raising activities, together with empirical evidence supporting the semi-strong version of the ECMH, tend to favor the use of mandatory disclosure rules and fraud-prevention disclosures. Rules encouraging disclosure also assist investors in achieving optimal portfolio diversification by giving them the information they need to make the requisite risk assessments. Disclosure rules are the historical regulatory core of the two initial (and, for my purposes here, key) federal securities laws: the Securities Act of 1933, as amended²⁸ (the 1933 Act) and the Securities Exchange Act of 1934, as amended²⁹ (the 1934 Act).

The most prominent feature of both the '33 Act and the '34 Act is the extent to which they require disclosure of information. The statutes and the regulations promulgated thereunder by the SEC contain detailed disclosure requirements and anti-fraud provisions to ensure that the disclosures are both complete and accurate. . . . Both Acts also incorporate specific anti-fraud provisions designed to ensure that all disclosures are accurate and free of fraud.³⁰

Mandatory disclosure under the 1933 Act and the 1934 Act is effectuated through the specific line-item disclosure rules in SEC forms (e.g., registration statements under both the 1933 Act and 1934 Act, and periodic reports, proxy statements and tender offer statements under the 1934 Act), including form requirements provided by reference to the integrated disclosure rules in Regulation S-K and Regulation S-X.³¹ In addition, the mandatory disclosure regime includes gap-filling rules that ensure that the disclosure of information in response to line-item requirements is not misleading as a result of the omission of important information not expressly required to be disclosed in response to the line-item requirements.³² Liability provisions like those in sections 11 and 12 of the 1933 Act³³ enforce these disclosure mandates. Antifraud rules in both

²⁷ See, e.g., Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 190–203 (2006).

²⁸ Securities Act of 1933, 15 U.S.C. §§ 77a–77aa.

²⁹ Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78pp (2006), amended by Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

³⁰ Carol R. Goforth, *Why Limited Liability Company Membership Interests Should Not Be Treated as Securities and Possible Steps to Encourage This Result*, 45 HASTINGS L.J. 1223, 1279–80 (1994) (footnotes omitted).

³¹ See 17 C.F.R. §§ 229.10–.703, 210.1-01–.12-29 (2012).

³² See, e.g., *id.* §§ 230.408, 240.12b-20.

³³ Securities Act of 1933 §§ 11, 12.

the 1933 Act and the 1934 Act reinforce this pro-disclosure norm and also address other deceptive and manipulative conduct in connection with financial transactions and governance activities relating to securities.³⁴

Disclosure is not enough to adequately protect investors and assure the markets' integrity. When disclosure's costs outweigh its benefits, it may have detrimental, rather than beneficial, effects on capital formation. There are many reasons why disclosure rules are not a securities regulation panacea. For one, mandatory and antifraud-based disclosure obligations in U.S. securities regulation are not as well-defined as they may appear. Disclosure rules in both contexts often require the release and dissemination of *material* information.

Core doctrine in federal securities law rests on a single word—*material*. Federal statutes and agency anti-fraud rules and disclosure requirements contain the term as an essential qualifier and identifier. *Facts* or *information* must be *material* before a legal obligation to disclose attaches. In other words, the term material has an unrivaled position in the center of all of securities law. Agency rules and court decisions applying the term necessarily establish the fundamental scope and bite of securities regulation.³⁵

Materiality is determined based on the application of a legal standard that does not always admit to clear application in practice.³⁶ Consequently, materiality can be idiosyncratic and difficult to determine in certain contexts.³⁷

³⁴ See, e.g., *id.* §§ 77q(a), 78j(b).

³⁵ Dale A. Oesterle, *The Overused and Under-defined Notion of "Material" in Securities Law*, 14 U. PA. J. BUS. L. 167, 167 (2011) (footnotes omitted).

³⁶ *Id.* ("A study of close to 800 cases in which a federal court applies the term to specific facts finds that the case-law is quixotic at best, and fickle at worst." (footnote omitted)).

³⁷ See Mark K. Brewer et al., *Reconsidering Disclosure and Liability in the Transatlantic Capital Markets*, 9 DEPAUL BUS. & COMM. L.J. 257, 283 (2011) ("While disclosure regimes require companies and financial institutions to provide all material information, the offeror of securities has significant discretion in determining which details it deems material."); Joan MacLeod Heminway, *Just Do It! Specific Rulemaking on Materiality Guidance in Insider Trading*, 72 LA. L. REV. 999, 1008 (2012) ("[F]acially simple articulations of a materiality standard make for difficult *ex ante* and *ex post* materiality determinations in many cases and allow for the exercise of significant enforcement discretion and hindsight bias by enforcement agents and judicial decision-makers."); Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call to Action*, 52 AM. U. L. REV. 1131, 1138–39 (2003) ("The interpretation and application of the materiality standard are highly fact-dependent and do not always produce predictable or certain planning options or judicial results.").

Assuming issues of materiality can be resolved, the next hurdle is packaging the relevant information in a manner that complies with any mandatory disclosure prescriptions and makes it accessible to the investor base. Often, the resulting disclosure—after information is sifted and materiality is carefully weighed—is lengthy and difficult to parse.

In practical terms, the disclosure that we see today in documents such as registration statements, proxy statements, annual reports, and financial documents is often too long and complex to be of much use to the ordinary investor. Prospectuses have become “so elaborate that many investors [are] unable to detect even blatant fraud solely by reading [them].” Many argue that our current financial disclosure rules require far too much nonessential data. Investors faced with this flood of information often lack the skills to identify what the information means or how to use it effectively. The complexity and detail in disclosure documents can make them almost incomprehensible at times, and the disconcerting truth is that investors will typically choose not to read documents that they know they will not understand. Disclosure cannot fulfill its communicative purpose if investors find it impenetrable and therefore ignore it.³⁸

While acknowledging the length and density of disclosures, commentators often assume that sophisticated investors, who are dominant traders in securities markets, possess the requisite knowledge and skill to evaluate accurate disclosures made by issuers of securities and others with disclosure responsibilities under federal securities regulation in the United States. However, issuers and their securities are increasingly complex.³⁹ This constantly evolving complexity and the mispricing of securities in the run-up to the recent financial crisis forces us to at least question the assumption that market participants can understand and absorb the information provided to them.⁴⁰ If a sufficient number of investors cannot

³⁸ Ripken, *supra* note 27, at 185 (footnotes omitted).

³⁹ See *id.* (“Part of the problem is that the structure and operations of business organizations today are more complex than ever, and the task of describing them in simplistic terms is almost impossible.”); Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1, 12–13 (2004) (describing the growing complexity by reference to Enron’s investment structures, but arguing it exists in other, more traditional organizations as well).

⁴⁰ See Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. 227, 276–78 (2009); Schwarcz, *supra* note 39, at 12–13. Misjudgments in trading before the financial crisis also may be attributable to cognitive biases and other errors. See generally Donald C. Langevoort, *Chasing the Greased Pig Down Wall Street: A*

fully comprehend and digest correct and complete information that is disclosed to them, they cannot use it to assess investment risks and effect market transactions, and the accuracy of market pricing will suffer.⁴¹

Disclosure also may be a suboptimal regulatory solution in U.S. securities law for reasons other than the vagaries of applicable legal standards and the complexity of the information being conveyed in the current environment. The sheer volume of disclosure occasioned by the mandatory disclosure regime—especially when some of the information has little, if any, relevance in determining market prices or company-specific or systemic risks—may render mandatory disclosure ineffective or inefficient in serving its desired regulatory objectives.⁴² Mandatory disclosure rules may be under-inclusive (failing to adequately anticipate and require disclosure of relevant or important information) and over-inclusive (requiring the disclosure of irrelevant or unimportant information).⁴³ Gap-filling and fraud-prevention rules help to address the under-inclusiveness problem through *ex post* enforcement mechanisms. If overused, however, mandatory disclosure prescriptions run a risk of burying market-relevant facts in an avalanche of disclosed facts.

Gatekeeper's Guide to the Psychology, Culture, and Ethics of Financial Risk Taking, 96 CORNELL L. REV. 1209 (2011) (offering significant description and analysis of the cognitive bias angle).

⁴¹ See Schwarcz, *supra* note 39, at 18 (“[W]ith complexity, few if any investors will actually understand the detailed disclosure. Thus, it is likely that less than a critical mass of investors will be able to understand the disclosure in order to act to achieve an ‘efficient’ market. It is even less likely that a critical mass of investors would be able to understand the disclosure in order to act *instantaneously* to achieve the efficient market.” (footnotes omitted)).

⁴² See Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1100 (1995) (“The issue is not the sheer quantity of data, but the amount of value-relevant information; if the mandatory disclosure system produces information that is irrelevant to stock prices, it does not meet the efficiency criteria of the accuracy enhancement model.”).

⁴³ See Bainbridge, *supra* note 17, at 1056 (“[T]he mandatory disclosure regime thus is likely to be under- and/or over-inclusive. Under-inclusive disclosure rules harm investors by denying them information they need. Over-inclusive rules harm investors by requiring the firm to spend money on unnecessary disclosures, which essentially comes out of the investors’ pockets.”); Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World*, 2 BROOK. J. CORP. FIN. & COM. L. 81, 116 (2007) (“An example of a regulatory regime gone astray would be a mandatory disclosure regime that focuses on requiring irrelevant information to be released. Indeed, some commentators have argued that this is what the SEC has done in regulations implementing the Securities Act of 1933 and the Exchange Act of 1934.”).

Moreover, while disclosure of market-relevant information is supported by the ECMH (helping to create more accurate pricing), it does not address behavioral biases that also may affect market pricing.⁴⁴

[A] growing body of research suggests that hypermotivated and super-optimistic insiders in firms may act irrationally in underestimating risks by “emphasizing positive returns as an indication of ability and downplaying trading losses as irrelevant.” Likewise, investors may exhibit “judgment biases that lead them to underestimate the risk that bad things will occur.” Furthermore, the proliferation of information in the age of the Internet where many investors rely less on experts to filter complex financial information may result in investors actually suffering from the requirements of securities regimes based on disclosure. As one expert notes, “[m]ore information alone cannot cure investors of the judgment biases that supposedly lead them to misuse the information.” Given all these contradictions to the assumptions underlying the efficient market theory, it is doubtful that disclosure in itself can adequately protect investors.⁴⁵

In short, “[d]isclosure may not protect investors if . . . cognitive biases inhibit them from rationally incorporating the disclosed information into their investment decisions.”⁴⁶ Irrational investment behavior detracts from accurate market pricing and decreases the efficiency of the securities markets.

Erroneous and misleadingly incomplete disclosures also cause inaccurate pricing.⁴⁷ The securities regulatory regime, therefore, addresses fraudulent and other significant misstatements and misleading omissions. Fraud and misstatements liability supplies both a means of incentivizing accurate and complete disclosures and provides opportunities for *ex post* enforcement when disclosures are incorrect or misleading by omission. Yet, fraud and misstatements liability (like mandatory disclosure regulation) has become particularly hard to navigate as financial instruments become ever more increasingly complex. “[A] disclosure-based regime can allow market participants to conceal investment risks behind opaque complex financial

⁴⁴ See Ripken, *supra* note 27, at 160–84 (describing various cognitive biases and their effect on the operation of the ECMH).

⁴⁵ Brewer et al., *supra* note 37, at 281 (footnotes omitted).

⁴⁶ Ripken, *supra* note 27, at 187.

⁴⁷ See Thomas A. Lambert, *Overvalued Equity and the Case for an Asymmetric Insider Trading Regime*, 41 WAKE FOREST L. REV. 1045, 1059 n.53 (2006) (“Even adherents of the semi-strong version of the Efficient Capital Markets Hypothesis admit that concealment or nondisclosure of material information may result in stock prices that fail to reflect the true value of the underlying securities.”).

instruments that neither sophisticated nor retail investors actually understand.”⁴⁸ The regulatory system is constantly playing catch-up in its effort to keep pace with market innovations—including those of bad actors.

Disclosure regulation through mandatory disclosure and antifraud and misstatement liability rules is a valuable tool, but its ability to fully address informational asymmetries and create accurate market pricing is uncertain. Although disclosure (whether mandated or offered to avoid fraud or misstatements liability) can be, and is, used to affect investor and issuer behavior, it is not always the best tool for that task. Substantive regulation is a more direct route to achieving behavioral changes. “Substantive regulation would involve mandating certain . . . conduct that we decide is beneficial and prohibiting particular conduct that we believe is unfair and improper. The goal of this type of regulation is to directly affect economic behavior, and not just demand the disclosure of information about that behavior.”⁴⁹

Regulators can, for example: limit the entities or individuals that may play certain roles or engage in certain types of transactions to specified entities or individuals; ban specified entities or individuals from playing certain roles or engaging in certain types of transactions; require entities or individuals to conduct their activities in a certain way (e.g., using specified intermediaries or procedures); or mandate, allow or prohibit specified types of transactions or transactional terms or provisions. Although substantive regulation has been a component of the U.S. securities regulatory scheme from its inception, its use has been growing in the new millennium. Examples of substantive regulation that existed before the new millennium can be found in the proxy rules adopted by the SEC in and under section 14(a) of the 1934 Act,⁵⁰ tender offer regulation in and under section 14(e) of the 1934 Act⁵¹ and the short-swing profit prohibition in and under section 16(b) of the 1934 Act,⁵² among other places. The Sarbanes-Oxley Act of 2002 and the resulting wave of SEC rulemaking added a number of substantive rules to the mix, especially in relation to the composition and operation of corporate boards of directors, and the Dodd-Frank Wall Street Reform and Consumer Protection Act continued this trend, perhaps most

⁴⁸ Brewer et al., *supra* note 37, at 282.

⁴⁹ Ripken, *supra* note 27, at 190.

⁵⁰ Securities Exchange Act of 1934 § 14, 15 U.S.C. § 78n(a) (2006); 17 C.F.R. §§ 240.14a-1–14b-2 (2012).

⁵¹ 15 U.S.C. § 78n(e); 17 C.F.R. §§ 240.14e-1–14f-1.

⁵² 15 U.S.C. § 78p(b); 17 C.F.R. §§ 240.16b-1–16b-8; *see also* Ripken, *supra* note 27, at 190 (“Section 16(b) of the Securities Exchange Act of 1934 is a good example of a substantive rule . . .”).

notably in the highly publicized “say on pay” and other corporate governance provisions.⁵³

Substantive regulation, as a more direct regulatory tool, can help protect securities investors and markets. In particular,

[s]ecurities regulation that is substantive and that prohibits improper behavior can help revive investor trust. Investor confidence increases, not decreases, with strong rules that go beyond mere disclosure to govern corporate conduct directly because such rules impose sanctions for non-compliant behavior, whether or not the non-compliance is disclosed and whether or not investors accurately process the disclosure.⁵⁴

However, when market participants and transactions are substantively regulated, that substantive regulation may proscribe efficient market activity and may create more clear channels for undesirable conduct (by-products of the same kind of over-inclusiveness and under-inclusiveness that exists in disclosure regulation).⁵⁵

In sum, the federal system of securities regulation in the United States uses disclosure regulation, fraud and misstatement liability and substantive regulation to promote investor protection, fair and honest markets and capital formation.

Government intervention in securities markets to put information in investors’ hands and to protect investors against corporate abuses serves a distributional goal by protecting investors against losses. Such government intervention also serves the larger goal of promoting capital formation and more efficient and liquid securities markets

⁵³ See Miriam H. Baer, *Choosing Punishment*, 92 B.U. L. REV. 577, 584 n.27 (2012) (“Although Dodd-Frank ostensibly was intended to respond to weaknesses in the regulation of financial institutions, Congress included a number of corporate governance provisions (say-on-pay and proxy access, for example)”); J. Robert Brown, Jr., *Corporate Governance, the Securities and Exchange Commission, and the Limits of Disclosure*, 57 CATH. U. L. REV. 45, 79 (2007) (“The Act interjected the Commission more deeply into the governance process, partly through the regulation of audit committees and partly through the authority to assign specific duties and obligations in connection with the development of internal controls.”).

⁵⁴ Ripken, *supra* note 27, at 194–95.

⁵⁵ See Schwarcz, *supra* note 39, at 21–23 (identifying these two drawbacks in discussing the potential effects of prohibiting structured transactions).

in that investor protection regulation can shore up investor confidence in the integrity of securities markets.⁵⁶

Principles from prevailing theory inform critiques of and adjustments to the existing regulatory system. This seamless inter-relationship of policy, theory and doctrine defines the nature and scope of U.S. securities regulation.

B. Securities

The concept of a security—the subject (and an object) of securities regulation—is significantly more complex than it appears. Most observers would readily identify equity instruments (i.e. common stock and preferred stock) and perhaps even some forms of indebtedness (e.g., debentures) as securities. However, few likely would know or be able to explain why certain types of indebtedness *are not* securities, or why a pay telephone or a tract of land in an orange grove, coupled with a related servicing agreement to provide for harvesting the coinage from the telephone or the fruit from the tract of land, respectively, *is* a security.⁵⁷ This part briefly summarizes the current U.S. federal law defining a security as a foundation for the observations and ideas that follow.

1. The Statutory Base

The classification of a financial interest as a security is, first and foremost, a statutory matter. Both the 1933 Act and the 1934 Act include statutory provisions defining what a “security” is.⁵⁸ They are similar, but not quite the same.⁵⁹ The structure of the definition is, however, identical under the two statutes.⁶⁰

⁵⁶ Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 1005 (2006) (noting that regulation in the name of investor protection may extend too far—to the extent that markets and capital formation are negatively impacted—stating “[s]ometimes, though, increased investor protection, such as through more mandatory disclosure and more aggressive SEC oversight and enforcement, can impede market participation and thus undercut the capital formation process and the efficiency and liquidity of securities markets”).

⁵⁷ See, e.g., *Sec. & Exch. Comm'n v. Edwards*, 540 U.S. 389 (2004) (involving the pay telephone scenario); *Sec. & Exch. Comm'n v. W. J. Howey Co.*, 328 U.S. 293 (1946) (involving the orange grove scenario).

⁵⁸ Securities Act of 1933 § 2, 15 U.S.C. § 77b(a)(1) (2006), *amended by* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012); Securities Exchange Act of 1934 § 3, 15 U.S.C. § 78c(a)(10) (2006), *amended by* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

⁵⁹ See 15 U.S.C. § 77b(a)(1); *id.* § 78c(a)(10); see also Miriam R. Albert, *The Howey Test Turns 64: Are the Courts Grading This Test on a Curve?*, 2 WM. &

Specifically, unless the circumstances dictate another result (i.e. “unless the context otherwise requires”), a financial interest is a security if it is included in a list of financial instruments (subject, under the 1934 Act, to certain exceptions).⁶¹ This list includes the usual suspects—e.g., stock, notes, bonds, debentures and options—as well as certain less familiar, more nebulous categories of financial instrument.⁶² These less familiar categories include, e.g., a “participation in any profit-sharing agreement” and an “investment contract.”⁶³ Neither of these terms is defined in either statute.⁶⁴ Both statutory provisions (under the 1933 Act and the 1934 Act) also include catchall clauses that incorporate into the definition “in general, any interest or instrument commonly known as a ‘security’”⁶⁵

These statutory definitions in the 1933 Act and the 1934 Act leave significant room for regulatory and judicial interpretation. In particular, the concept of “context” raises questions about the status of instruments labeled as, e.g., stock and notes.⁶⁶ In addition, the less familiar (profit-sharing participation and investment contract) and catchall categories of instruments require supplementary definitional content in order to have meaning. Some of these labeling questions have been answered, and some

MARY BUS. L. REV. 1, 5–6 (2011); C. Steven Bradford, *Expanding the Investment Company Act: The SEC’s Manipulation of the Definition of Security*, 60 OHIO ST. L.J. 995, 999 (1999); James D. Redwood, *Toward a More Enlightened Securities Jurisprudence in the Supreme Court? Don’t Bank on It Anytime Soon*, 32 HOUS. L. REV. 3, 4 n.2 (1995). The two definitions typically are treated as substantial equivalents. *See, e.g.,* Marine Bank v. Weaver, 455 U.S. 551, 555 n.3 (1982) (“We have consistently held that the definition of ‘security’ in the 1934 Act is essentially the same as the definition of ‘security’ in § 2(1) of the Securities Act of 1933”); United Hous. Found., Inc. v. Forman, 421 U.S. 837, 847 n.12 (1975) (“The definition of a security in § 3(a) (10) of the 1934 Act . . . is virtually identical [to the definition in the Securities Act of 1933] and, for present purposes, the coverage of the two Acts may be considered the same.” (citations omitted)); Tcherepnin v. Knight, 389 U.S. 332, 342 (1967) (“The same Congress which passed the Securities Act in 1933 approved the Securities Exchange Act in 1934, and the definition of security contained in the 1934 Act is virtually identical to that in the earlier enactment.”).

⁶⁰ *See* JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 19 (6th ed. 2009).

⁶¹ 15 U.S.C. §§ 77b(a)(1), 78c(a)(10).

⁶² *See id.*

⁶³ *Id.*

⁶⁴ *See, e.g.,* Albert, *supra* note 59, at 6 (noting that the “investment contract” term is not defined in either the 1933 Act or the 1934 Act).

⁶⁵ 15 U.S.C. § 77b(a)(1); *see also id.* § 78c(a)(10).

⁶⁶ *See, e.g.,* Reves v. Ernst & Young, 494 U.S. 56 (1990) (analyzing notes as a security); United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975) (analyzing stock as a security).

of the detailed definitional content has been supplied in the almost eighty years since Congress enacted the statutes.

2. *The Important Role of Decisional Law*

Because the SEC has not regulated significantly in this area, most of the heavy lifting in answering labeling questions and defining substantive content has been left to the federal courts. U.S. federal decisional law defining a security has engaged a variety of issues over time. The standard securities regulation casebook samples liberally from this rich body of law⁶⁷ to help students learn how to analyze and resolve important issues related to both the offer and sale of financial interests in business firms and the governance rights of the holders of those financial interests. The opinions in these cases provide significant, but not comprehensive, guidance.

Although there are key cases analyzing, e.g., when stock and debt instruments are (and are not) securities,⁶⁸ many of the most significant and difficult cases involve determinations of whether particular financial interests are investment contracts (and therefore securities).

These judicial decisions take into account, to varying degrees, the underlying legislative purposes of the federal securities laws to provide investor protection through mandatory disclosure of the information investors need to make informed investment decisions and, through anti-fraud liability, to put some teeth into the mandatory disclosure requirements by imposing significant penalties for violations thereof. As a result of the disclosure requirements and anti-fraud liability, investors and securities markets arguably will have the information needed to move capital to its optimal uses.

These judicial decisions also reflect the desire for flexibility that is manifest in the legislative history of both the 1933 and 1934 Acts. Congress intentionally avoided a rigid statutory definition of security in an effort to give the courts flexibility in interpreting this important and far-reaching concept.⁶⁹

⁶⁷ See, e.g., COX ET AL., *supra* note 60, at 20–90.

⁶⁸ See *Reves*, 494 U.S. at 64–67 (outlining and adopting the family resemblance test for determining whether notes are securities); *Forman*, 421 U.S. at 851 (describing attributes of stock that make it a security).

⁶⁹ Albert, *supra* note 59, at 6–7 (footnotes omitted).

The seminal case defining an “investment contract” is the *Howey* case.⁷⁰ In this landmark opinion on the status of financial interests under U.S. securities law, the Court determined that

an investment contract . . . means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.⁷¹

This definition has become the touchstone for determining investment contract status under both the 1933 Act and the 1934 Act.

In a later case, the Court indicated that an investment contract is the equivalent, for definitional purposes, of an “interest or instrument commonly known as a ‘security.’”⁷² Lower courts have found that the *Howey* test also describes or helps identify a “participation in any profit-sharing agreement” for purposes of the statutory definition of a security.⁷³ The “investment contract” aspect of the definition of a “security” in the 1933 Act and the 1934 Act provides the background for new observations about the concept of a security in the crowdfunding era.⁷⁴

III. CROWDFUNDED OFFERINGS AND CROWDFUNDING INSTRUMENTS BEFORE THE JOBS ACT

The advent of crowdfunding has put significant pressure on the regulation of securities under the 1933 Act and the 1934 Act, in general, and the definition of a security, in particular. Crowdfunding, as originally

⁷⁰ Sec. & Exch. Comm’n v. W. J. Howey Co., 328 U.S. 293 (1946).

⁷¹ *Id.* at 298–99.

⁷² *Forman*, 421 U.S. at 852 (“We perceive no distinction, for present purposes, between an ‘investment contract’ and an ‘instrument commonly known as a ‘security.’”).

⁷³ See, e.g., *Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96, 102 (7th Cir. 1977) (“[C]ourts have made no real distinction between investment contracts and profit-sharing plans.”); *Trostle v. Nimer*, 510 F. Supp. 568, 572 (S.D. Ohio 1981) (noting that “[i]n most contexts,” the two are synonymous).

⁷⁴ See, e.g., C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 30–42 (2012); Edan Burkett, *A Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation*, 13 TRANSACTIONS: TENN. J. BUS. L. 63, 79–82 (2011); Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1739–40 (2012); Joan MacLeod Heminway & Sheldon Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 885–906 (2011).

conceived, was a form of crowdsourcing financial capital.⁷⁵ It allows entrepreneurs to use an Internet-based “crowd” to fund their ventures.⁷⁶ The growing success of crowdfunding eventually compelled federal and state regulatory interest, since many of the crowdfunding sites were offering (or desired to offer) interests in businesses or projects that were (or might be deemed to be) securities.⁷⁷ In an ostensible bid to harness the potential power of crowdfunding for the benefit of these entrepreneurs,⁷⁸ Congress passed the CROWDFUND Act as part of the JOBS Act, and the President signed it into law in the spring of 2012.⁷⁹

⁷⁵ See, e.g., Paul Belleflamme et al., *Crowdfunding: Tapping the Right Crowd 2* (Apr. 25, 2012) (unpublished manuscript), available at <http://ssrn.com/abstract=1578175> (“The concept of crowdfunding finds its root in the broader concept of crowdsourcing.”); *id.* at 6 (“[T]he concept of crowdfunding can be seen as part of the broader concept of crowdsourcing, which refers to using the ‘crowd’ to obtain ideas, feedback and solutions in order to develop corporate activities.”); Kristina Dell, *Crowdfunding*, TIME, Sept. 4, 2008, <http://www.time.com/time/magazine/article/0,9171,1838768,00.html> (“The term crowdfunding derives from another neologism: crowdsourcing, i.e., outsourcing to the public jobs typically performed by employees.”); ARMIN SCHWIENBACHER & BENJAMIN LARRALDE, *HANDBOOK OF ENTREPRENEURIAL FINANCE* 373 (2012) (“Crowdfunding can be viewed as an element of crowdsourcing.”).

⁷⁶ See, e.g., Belleflamme et al., *supra* note 75, at 2 (“[I]nstead of raising the money from a very small group of sophisticated investors, the idea of crowdfunding is to obtain it from a large audience (the ‘crowd’), where each individual will provide a very small amount.”); C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L.J. (forthcoming Fall 2012) (manuscript at 2), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2066088 (“Crowdfunding is the use of the Internet to raise money through small donations from a large number of people—the ‘crowd’ in crowdfunding.”).

⁷⁷ See Bradford, *supra* note 76 (manuscript at 5–6); Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433, 1436–38 (2012); Heminway & Hoffman, *supra* note 74, at 882–84.

⁷⁸ Views on whether Congress is, in fact, supporting entrepreneurialism through the CROWDFUND Act and the greater JOBS Act are uncertain and decidedly mixed. See Catherine Clifford, *Crowdfunding’s Wild West Awaits a Stampede*, ENTREPRENEUR (Mar. 28, 2012), <http://www.entrepreneur.com/article/223234>; Steven M. Davidoff, *From Congress, a Law Befitting a Sausage Factory*, N.Y. TIMES DEALBOOK (Apr. 3, 2012, 4:18 PM), <http://dealbook.nytimes.com/2012/04/03/from-congress-a-law-befitting-a-sausage-factory/>; Nick Jensen, *New Law Will Help Entrepreneurs Raise Money: Crowdfund Act*, UNDER30CEO (Apr. 6, 2012), <http://under30ceo.com/new-law-will-help-entrepreneurs-raise-money-crowdfund-act/>.

⁷⁹ See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (to be codified in scattered sections of 15 U.S.C.). The CROWDFUND Act is Title III of the JOBS Act. See *id.* §§ 301–05

A. Crowdfunding Models

The market for crowdfunding and crowdfunded interests in business ventures that developed before enactment of the JOBS Act (and that has continued after its adoption, but before its full implementation) resulted from creative and, in some cases, bold entrepreneurial decision-making and action. Crowdfunding has been used to support both entity-based capital formation (i.e. financing for an entire firm) and project-based business initiatives (typically, for sole proprietors or small groups of individuals—like indie and rock bands—that the law likely would characterize as partnerships in the absence of a more formal chartered entity status). Crowdfunding has been employed to finance traditional for-profit businesses, traditional non-profit businesses and social enterprises that combine a prototypical investor profit-maximization orientation with objectives that maximize environmental or social utility.

A number of different taxonomies have been introduced to describe the types of funding sites and financial interests that developed during this time. Professor Steven Bradford offers and describes one of these taxonomies in a recent law journal article.⁸⁰

One can categorize crowdfunding into five types, distinguished by what investors are promised in return for their contributions: (1) the donation model; (2) the reward model; (3) the pre-purchase model; (4) the lending model; and (5) the equity model. Some crowdfunding sites encompass more than one model; it is especially common to see the reward and pre-purchase models on a single web site. Other sites rely on only a single model.⁸¹

Another taxonomy differentiates crowdfunding into two forms, based on the existence of a consumption interest on the part of the funder,⁸² while

⁸⁰ See Bradford, *supra* note 74, at 14–27.

⁸¹ *Id.* at 14–15.

⁸² Belleflamme et al., *supra* note 75, at 3 (“In the first form, consumers are invited to pre-order the product. For the entrepreneur to be able to launch production, the amount collected through pre-ordering must cover the required amount of capital. Since the remaining consumers will pay a different price when the product is on the market, crowdfunding that takes the form of pre-ordering gives the opportunity to price discriminate between the first group (those who pre-order and thus constitute the funding ‘crowd’) and the second group (the other ‘regular’ consumers who wait that [sic] production takes place before purchasing directly). This form of crowdfunding appears thus as a special form of behavior-based price discrimination, since consumers self-select themselves in one of the groups based on their personal preferences. In the second form of crowdfunding, individuals are invited to provide money to the entrepreneur in exchange for a share of the profits

yet another (along similar lines) “distinguishes ‘*ex post facto* crowdfunding,’ where financial support is offered in exchange for a completed product, from ‘*ex ante* crowdfunding,’ where . . . financial support is given on the front end to assist in achieving a mutually desired result.”⁸³ Nonprofit crowdfunding can be distinguished from for-profit crowdfunding, and for-profit crowdfunding may or may not offer equity participation to funders.⁸⁴ Finally, “patronage crowdfunding,” which focuses on generating donated funds, can be differentiated from “investment crowdfunding,” which focuses on generating equity, debt or another similar financial interest in the funded business or project.⁸⁵

These taxonomies are individually useful in context for the purposes for which they are offered; collectively, they help to identify both familiar and new attributes of an innovative and less-defined venture finance market in different analytical contexts. In the aggregate, they serve an important role: they clarify that funding interests sold and bought through crowdfunded offerings are non-uniform. These interests come in many flavors. Some look more like charitable or other non-profit contributions, some may seem akin to gambling bets and some resemble traditional equity and debt interests. Some provide profit-sharing or revenue-sharing opportunities; some do not. Among crowdfunding interests that include the promise or possibility of current returns, some offer those returns for a short period only; others, for the life of the entity or project. The non-financial investor benefits embedded in these crowdfunding interests also vary significantly. They may include, for example, tangible, consumer entitlements or psychological or emotional affects. In this less-defined, highly contractual investment environment, the dividing line between securities and non-securities, as currently construed and applied, is somewhat unclear and, even when clear, may be artificial or arbitrary.⁸⁶ Crowdfunding interests regulated as securities are regulated under the relatively weighty realm of securities regulation (federal and state), while those that are not securities are subject to a different regulatory regime (e.g., charitable or other nonprofit donation, gambling or consumer protection regulation). The potential for confusion among crowdfunding participants (funders, website

or even to purchase equity securities issued by the entrepreneurial form. These investors may or may not decide to become consumers in a later stage.”).

⁸³ Tim Kappel, *Ex Ante Crowdfunding and the Recording Industry: A Model for the U.S.?*, 29 LOY. L.A. ENT. L. REV. 375, 375 (2009).

⁸⁴ See Nikki D. Pope, *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption*, 13 U. PA. J. BUS. L. 973, 977–81 (2011).

⁸⁵ See Burkett, *supra* note 74, at 64.

⁸⁶ See Heminway & Hoffman, *supra* note 74, at 885–906 (analyzing crowdfunding interests as securities); *id.* at 895 n.76 (noting that the application of securities regulation to crowdfunding may depend on small differences in funding models).

owners and providers and the venturers whose operations or projects are being funded)—and regulatory mayhem—is evident.

B. *Crowdfunded Business Interests at the Margin*

Close to this dividing line between crowdfunded securities and crowdfunding interests that are not classifiable as securities is a particular type of financial interest that provides for profit-sharing or revenue-sharing on a short-term basis, with no accompanying governance rights.⁸⁷ This type of interest *is* a security, but it is neither debt (because the funded business or project has no obligation to repay the funder) nor traditional equity (which typically combines, based on statutory mandate or contractual provisions, financial and governance rights); it is properly classified as a form of investment contract.⁸⁸ The use of investment contracts of this kind—*unequity*—became more prominent in the crowdfunding environment that existed in the year or two before the U.S. federal government began to take an interest in crowdfunding—the time period leading up to Congress’s adoption of the JOBS Act. Entrepreneurs were creatively innovating new funding models that were designed to operate in a business finance “sweet spot” that leverages social-network-like tools to raise capital while avoiding the significant strictures of securities regulation (or so they hoped). It was the Wild West of crowdfunding: a rough-and-tumble period characterized by fast growth and legal risk-taking bordering on lawlessness.

None of the taxonomies of crowdfunding adequately account for *unequity*, likely because little attention has been given to this type of investment interest in debates over the wisdom and efficacy of crowdfunding. Yet, upon the authorization of crowdfunded securities offerings under the JOBS Act, businesses and projects may lawfully be funded through the sale of *unequity* interests as well as more traditional, mainstream debt, equity, convertible, exchangeable and derivative interests. Offers and sales of (and other transactions involving) *unequity* raise some, but not all, of the same questions and concerns for issuers and investors that transactions in conventional securities raise for issuers and investors. An understanding of *unequity* enables a more full understanding of the panorama of financial and related interests⁸⁹ and instruments that exist and

⁸⁷ The interests offered on the now-defunct crowdfunding site 33needs.com are examples of this kind of security. See, e.g., *id.* at 891–904 (using 33needs.com as an example of a crowdfunding interest that is an investment contract).

⁸⁸ See *id.* at 885–906.

⁸⁹ The concept of “related interests” referenced throughout the remainder of this essay captures both the reality that non-financial interests are associated with and embedded in traditional financial instruments and the further thought that interests outside the traditional realm of financial interests (e.g., consumer interests, charitable and other nonprofit donative interests and interests in gambling

offers us a spectrum of interests and instruments that may be subject to regulation in various contexts.

This spectrum of available and foreseeable financial instruments, representing a significant variety of financial and related interests, is important to the future of financial regulation. Identifying the points—large and small—arrayed across this continuum is one of the unmet challenges in reforming or redesigning the system of financial regulation in the United States and elsewhere. It may be useful, for these purposes, to broaden the set of interests considered to include related non-financial interests (which may be bundled with financial interests in some financial instruments). For example, based on the nature and extent of a funder's claim to pecuniary assets of the venture (or the corresponding right of the venture to retain the funding) offered in return for the interest offered, one might identify the spectrum as ranging from (on one end) interests in goods and services—consumer or consumptive interests, not pure financial interests—extending through financial and related interests in the nature of charitable or other nonprofit donations, gambling wagers, franchises, debt securities, equity securities and commodities, and ending (on the other end of the spectrum) with insurance and banking interests (and I am sure I am missing some types of interest along the way). The range of interests and instruments could also be defined by other identifying characteristics, including the nature of the funder's claim to assets of the venture, if any (e.g., an interest in goods or services, a claim to winnings from a game of chance, a right of repayment, an short-term or long-term interest in the financial returns of the venture or some combination of these and other interests). Policy and theory are important to determining the attributes that may be of interest to lawmakers, since the protection of the funder's interests is among the objectives served by financial regulation.

In designing an appropriate and comprehensive system of regulation, the first step is identifying these financial and related interests in some detail. The next step involves identifying the significant financial and non-financial attributes of the interests that comprise the spectrum and deciding how (if at all), looking across this spectrum, these diverse instruments should be regulated and in what contexts. Essentially, this involves matching financial interests and instruments with regulatory structures and directives that meet policy goals and account for applicable theory.

proceeds) may be arrayed with financial interests to form a more complete picture of regulated interests emanating from pecuniary contributions to an enterprise.

IV. MATCHING REGULATORY FRAMEWORKS TO INTERESTS AND
INSTRUMENTS

A closer look at the organic growth of crowdfunding in its early years offers the opportunity—one among many, of late—to reflect on the regulatory framework governing financial instruments. In the years following the financial crisis, in particular, scholars and policy makers have taken aim at the nature of financial regulation in the United States and found the current structures and substantive provisions wanting. In particular, numerous commentators have noted that the siloed nature of the regulatory system for these instruments in the United States—regulation that relies on the categorization of an instrument by type and the relegation of each type of financial interest or instrument to its own body of regulation—is outdated in an era of financial products that combine attributes of historically distinct instruments.⁹⁰

However, much (but not all) of the discussion on financial regulatory reform has focused on sophisticated financial institutions—including banks, securities firms and insurance companies—and instruments, especially those representing interests in securitized pools of assets, insurance products, commodities, swaps, etc.⁹¹ Unequity adds a new piece to the puzzle. Currently, it is regulated as a security. But should it be? Although in my prior work on specialized law reform focusing on crowdfunding I, together with a coauthor, determined not to tinker with the regulation of unequity as a security,⁹² that simple answer to the question seems inadequate in the face of the larger task of regulatory reform and design. The regulation of financial interests, instruments and offerings can and should be rethought with the less sophisticated interests and instruments in mind, as well as the more sophisticated interests and instruments.

⁹⁰ See, e.g., Eric C. Chaffee, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: A Failed Vision for Increasing Consumer Protection and Heightening Corporate Responsibility in International Financial Transactions*, 60 AM. U. L. REV. 1431 (2011); Saule Omarova & Adam Feibelman, *Risks, Rules, and Institutions: A Process for Reforming Financial Regulation*, 39 U. MEM. L. REV. 881 (2009).

⁹¹ See, e.g., Elizabeth F. Brown, *The New Laws and Regulations for Financial Conglomerates: Will They Better Manage the Risks Than the Previous Ones?*, 60 AM. U. L. REV. 1339, 1341 (2011) (analyzing financial conglomerates—firms that own securities, insurance and depository institutions); Houman B. Shadab, *Guilty By Association? Regulating Credit Default Swaps*, 4 ENTREPREN. BUS. L.J. 407, 419–30 (2010) (describing the regulation of and regulatory reforms applicable to credit default swaps); Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U. L. REV. 1, 5 (2010) (focusing on banks, securities firms and insurance companies).

⁹² See Heminway & Hoffman, *supra* note 74, at 941–42.

How might we go about the task of thinking through this recasting of our financial regulatory structure in the United States knowing what we now know about financial and related interests across a broad spectrum from consumer interests to interests in bank deposits? A few years ago, Professors Saule Omarova and Adam Feibelman made some valuable observations, advising general caution in approaching financial regulatory reforms:

There may be several methods of drawing the regulatory and supervisory lines: by product or function, target customer base, size and complexity of operations, and so forth. It is essential to keep an open mind about the outcome of this inquiry. In the process of gathering, processing, and analyzing empirical information about today's financial industry, the outlines of potential new substantive approaches to regulation and supervision will inevitably begin to take shape.⁹³

This essay, in essence, picks up one of the threads of analysis suggested by Professors Omarova and Feibelman—by preliminarily suggesting a more inclusive way in which regulatory and supervisory lines may be drawn by product. The nascent ideas shared here with regard to the characteristics of financial and related interests and instruments establish a basis for further thought and study and (possibly) action in reforming or redesigning the overall framework of financial regulation.

A. Salient Attributes of Financial Regulatory Systems and Financial Instruments

Financial regulation in the United States has been constructed on the basis of individualized financial institutions and the instruments they design and offer. Yet, these lines have become blurred.

The financial services industry has seen a significant convergence of the banking, securities, and insurance market segments in recent years. Unfortunately, regulatory architecture in the United States has not adapted to reflect changing industry configurations. Rather, U.S. regulatory architecture has remained complex and fragmented in the face of industry “consolidation,” “conglomeration,” and “convergence.”⁹⁴

⁹³ Omarova & Feibelman, *supra* note 90, at 919 (footnote omitted).

⁹⁴ Olufunmilayo B. Arewa, *Risky Business: The Credit Crisis and Failure (Part I)*, 104 NW. U. L. REV. COLLOQUY 398, 413–14 (2010) (footnotes omitted).

In our current world of hybridized financial institutions and interests, this regulatory framework simply is no longer rational or feasible. Other national governments have moved away from a scheme of regulation founded on distinct areas of financial regulation based on characterizations of instruments along identifiable product lines and toward other regulatory models that focus on, e.g., common risks. In addition to its untenable basis in increasingly indistinct product categories, the current U.S. regulatory framework has a number of disadvantages, including a multiplicity of regulators at the federal and state levels of government.

The U.S. remains distant from the international trend toward integrated supervision. Banking, securities, and insurance regulators remain separate. Moreover, even within each of these traditional regimes, there are multiple regulators, i.e., multiple bank regulators, multiple securities regulators, and multiple insurance regulators.⁹⁵

The existence of multiple regulators and regulatory frameworks masks significant similarities in both the separately governed instruments and the nature of the regulatory mandates. In fact, there is much commonality in the regulated instruments and the distinct systems of regulation that constitute U.S. financial regulation. The regulated instruments typically are forms of personal property. And the various existing systems of regulation all have common policy roots in protecting the owners of those instruments (funders) from fraud, deception and other business practices that are, in some way, unfair.⁹⁶ At the same time, these systems of regulation also protect the industries and markets that they regulate—deeming those industries and markets worthy of encouragement.

One result, based on commonalities in applicable theories linking information to transparency and markets, is that the components of the existing regulatory framework rely heavily on disclosure as a regulatory tool.⁹⁷ The nature and extent of disclosure does, however, differ, given that

⁹⁵ Heidi Mandanis Schooner, *The Role of Central Banks in Bank Supervision in the United States and the United Kingdom*, 28 BROOK. J. INT'L L. 411, 440 (2003).

⁹⁶ See, e.g., Peter C. Lagarias & Robert S. Boulter, *The Modern Reality of the Controlling Franchisor: The Case for More, Not Less, Franchisee Protections*, 29 FRANCHISE L.J. 139, 139–40 (2010) (“Franchise disclosure legislation followed employment, securities, banking, insurance, and other regulations implemented to temper abuses in the free-market economy. Core concerns leading to most such remedial legislation were fraud and other unfair or deceptive practices.”).

⁹⁷ See, e.g., Ripken, *supra* note 27, at 153 n.44 (“Disclosure is a remedy for informational asymmetries in markets other than securities as well. For example, information disclosure can be beneficial in the context of healthcare.”); Cass R. Sunstein, *Paradoxes of the Regulatory State*, 57 U. CHI. L. REV. 407, 424 (1990) (“Congress and agencies have imposed disclosure regulations in many areas,

the underlying theories vary in their application to different industries and markets and the behavior of participants in those markets. Disclosure requirements do and should vary based on context. Some requirements, including the mandatory disclosure requirements in securities regulation, are more in the nature of principles and are imposed and employed in decision-making *ex ante*; others, including the antifraud provisions in federal securities regulation, are more in the nature of standards that may impact *ex ante* decision-making but are applied *ex post* in enforcement proceedings.

Yet, there also are significant differences in existing regulated instruments and in the regulatory systems comprising the current U.S. financial regulatory framework. Some of these systems engage other, more substantive, regulatory tools that are more intrusive on the nature of the operations of the regulated businesses. These other regulatory tools include, for example, “activity restrictions, capital adequacy requirements, reserve requirements, conditions on affiliate transactions, . . . etc.”⁹⁸ Traditional consumer product and service regulation, for example, typically includes few of these more intrusive, paternalistic tools of regulation.⁹⁹ Banking regulation includes many.

Bank regulation tends to be protective or paternalistic. The agency restricts the number of firms that can enter the banking business, and deals with banks’ financial problems secretly for fear of precipitating a “run on the bank.” In the securities business, on the other hand, there are no restrictions on entry, and the whole regulatory emphasis is on full disclosure—making all the bad news publicly available and letting the market decide.¹⁰⁰

Although the specific regulatory tools along this continuum are virtually infinite, the range of tools is well understood and forms a basis for the design and construction of a more comprehensive and fluid financial regulatory structure.

The similarities and differences in corporate finance instruments and regulatory rules and norms raise questions about optimal financial regulation. If we can adequately sort through the different types of financial

ranging from occupational and environmental risks to potentially deceptive advertising.”).

⁹⁸ Omarova & Feibelman, *supra* note 90, at 884.

⁹⁹ See Kurt Eggert, *Striking a Balance: Basic Questions About Consumer Protection Law*, 7 CHAP. L. REV. 1, 8 (2004) (noting that, in consumer protection regimes, “[r]estrictions on types or terms of agreements and banning certain abusive practices are less universally popular”).

¹⁰⁰ David L. Ratner, *The SEC at Sixty: A Reply to Professor Macey*, 16 CARDOZO L. REV. 1765, 1773 (1995).

and related interests and plot them across a spectrum—or perhaps even multiple spectrums or dimensions of a spectrum based on various factors related to policy and theory—then we should be able to match the interests to different regulatory tools based on underlying policy and theory and construct a more sound and rational overall framework for financial regulation in the United States—and, perhaps, in time, for the world as a whole.¹⁰¹ I am not alone in suggesting that the prudent reconstruction of financial regulation begins with a detailed assessment of the existing landscape.

Various structural factors, including increasing globalization of financial markets, growth of large financial conglomerates with international operations, convergence of financial products and services traditionally offered by institutions separated by sectoral lines, and rising importance of institutional investors, have rendered many of the traditional regulatory boundaries among different categories of financial institutions such as commercial banks, thrifts, securities and insurance firms, etc., largely meaningless and inefficient. Thus, the first step in the process of a comprehensive regulatory reform should focus on re-drawing the relevant boundaries within the modern financial services sector, that is, redefining the relevant segments of the industry and assessing the key risks inherent in each segment.¹⁰²

I contend, as Professors Omarova and Feibelman suggest, that to re-draw these boundaries and redefine these industrial segments, we must first focus on the nature of the full spectrum of financial and related interests and instruments that exist and can be envisioned. Unequity and other less sophisticated instruments should be factored into this spectrum.

B. Regulation of Financial Interests and Instruments Across One or More Spectrums

A foundational task, then, for those bent on financial regulatory reform is to identify the full range of financial and related interests and array them across one or more spectrums based on their salient attributes. The focus of this exercise should be on the market participants intended to be protected by the regulation—those who will acquire, use, dispose of and otherwise

¹⁰¹ This essay assumes that, for the foreseeable future, financial regulation will continue to be the province of national governments, despite the global nature of financial services and transactions.

¹⁰² Omarova & Feibelman, *supra* note 90, at 911–12 (footnote omitted).

transact in or conduct businesses that relate to the instruments that embody these interests—as well as the markets themselves.

As part of this dual-track exercise of articulating regulatory objectives and lining up regulatory techniques, policymakers will have to define and redefine key regulatory boundaries within the financial industry. Which types of business activities or market segments should be grouped together and be regulated under a common scheme? Conversely, which types of activities or market segments should be separated for regulatory purposes? And should such activities be conducted in separate entities subject to different regulatory regimes? These decisions are likely to be based, among other factors, on the types of risks embedded in the nature of the given business activities, the dynamics of the relevant market, and the role of various types of financial institutions within these markets.¹⁰³

Each of these factors may be the basis of a distinct spectrum of regulated products or transactions or business activities or markets. What similar and different risks are attendant to consumer products producers and services providers, charities and other nonprofit entities, gambling establishments, franchises of various kinds, small-cap, mid-cap and large-cap issuers of unequity, debt and equity, insurance firms, financial services firms, etc.? What common and unique dynamics exist in the markets for the various different products, services, financial and related interests and instruments that these businesses purvey? And what role do various commercial, investment and other economic or monetarily-oriented principals and intermediaries play in these markets?

This essay is designed to further the conversation on financial regulation in a limited way by identifying securities as an important and diverse set of regulated instruments. Securities, often treated in the regulatory framework as somewhat homogenous, reflect, in and of themselves, a broad range of different financial and related interests. These interests are embedded in a variety of instruments that extend from unequity in the form of investment contracts (which, in the crowdfunding era, have often represented merely a short-term, limited claim to profits or revenues, with no governance engagement), through common stock and preferred stock, to secured debt (which represents a more assured claim on the funded venture). As the United States rethinks its financial regulatory framework, policy makers should take account of the full array of interests and instruments commonly identified as securities.

¹⁰³ Omarova & Feibelman, *supra* note 90, at 916–17.

C. Situating Securities in the Spectrums of Financial and Related Interests and Instruments

Based on the nature of the regulatory tools employed, the existing system of securities regulation is somewhere in the middle of the current financial regulatory landscape in the United States. Securities regulation (like the regulation of consumer products and services, charitable and other nonprofit enterprises, gambling establishments, insurance providers and banks) engages disclosure as a prominent regulatory tool. Yet, securities regulation does not employ the kinds of heavy-handed substantive regulation of financial condition imposed on the insurance and banking industries, including the “prudential” safety-and-soundness strictures that are distinctive to banking regulation.¹⁰⁴ Securities regulation does, however, engage in some forms of substantive regulation that distinguish it from a legal governance regime based solely or almost exclusively on disclosure controls.¹⁰⁵

Is this where the regulation of securities belongs in the overall national financial regulatory structure? Does it make sense to regulate all instruments classified as securities in a way that is common as among securities and distinct from interests in consumer products, the operations of charitable and other nonprofit enterprises, the proceeds of games of chance, the benefits payable under insurance contracts and bank deposits? Core commonalities, including the need to correct information asymmetries, argue for a common system of regulation, yet important differences among securities (specifically) and financial and related interests and instruments (more generally) remain.

To locate securities in potential spectrums of financial and related interests that provide a basis for regulatory reform requires, first, that we characterize both the spectrum and the different types of securities in more detail. Although all securities assume the potential to make money by parting with money, the similarities may end there. Crowdfunding interests in the form of investment contracts are especially difficult to categorize since the range of terms they may embody is particularly fluid. Investors may have mixed motives in purchasing them. While they have an expectation of “profits” generated by from a common enterprise and by the efforts of others,¹⁰⁶ they also may acquire these financial and related interests with the clear understanding that they will have no governance rights over the enterprise and will never recoup the full value of their investment through current returns, repayment or resale. They may just

¹⁰⁴ See, e.g., Joseph Jude Norton, *Capital Adequacy Standards: A Legitimate Regulatory Concern for Prudential Supervision of Banking Activities?*, 49 OHIO ST. L.J. 1299, 1300 n.4 (1989) (defining prudential regulation).

¹⁰⁵ See *supra* notes 49–55 and accompanying text.

¹⁰⁶ See *Sec. & Exch. Comm’n v. W. J. Howey Co.*, 328 U.S. 293, 298–99 (1946).

want a small amount of “skin in the game” in supporting the development of a business or project. This limited profit motive does not make these investors irrational, however. They may just be maximizing utility in a different, more complex way. The reasons these investors have for funding a business or project may be mixed. Their motives, in addition to monetary rewards, may be, for example, consumptive (if they are also getting a product or service—a consumption interest—in return for funding the business or project) or altruistic (bettering society). Existing discussions and models have failed to take these unequity interests into account.

Crowdfunding interests, including unequity, that developed in the era preceding the JOBS Act illustrate that securities are more complex than the current system of securities regulation may contemplate. For instance, the existing system of securities regulation all but effectively ignores the complexity of unequity in employing many of its regulatory tools, just as it ignores the complexity of more sophisticated financial instruments classified as securities—those that share attributes with commodities, insurance or banking products. The risks and rewards of unequity are not merely the risks associated with consumer products and services, charitable and other nonprofit donations or gambling bets. They also are not the same risks and rewards that are associated with traditional equity and debt instruments classified as securities—which tend to be longer-term and include statutory and contractual governance rights. And the risks and rewards of unequity most certainly are not the risks and rewards associated with insurance products or bank deposits.

Therefore, an important task for those of us who understand the full range of instruments classifiable as securities is to create a better taxonomy of these instruments by looking more closely at the financial and related interests that characterize these instruments and assessing them in light of applicable theory and the policy interests to be served by comprehensive financial regulation. This is a tall order and a task that should be approached in a thorough, methodical manner. It should involve participation by the regulators and the regulated and, yes, by those of us in the academy. Financial regulation is too important to our economy, our society—our lives—to be determined by political forces disconnected from detailed knowledge of the interests, instruments, transactions and markets at issue. This knowledge is built from many sources (experience, empirical studies, etc.).

Perhaps this effort will reveal that the common attributes of financial and related interests and instruments, the enterprises that offer and sell them, and the markets in which they are offered and sold make a junction-box regulatory system desirable—a system of regulation in which the common regulatory tools are all found in one statutory or other body of rules, governed by a single regulator, with specialized bodies of rules and personnel for financial products and offerings that have certain distinct

identifiable attributes. A single instrument offered in a specific way might engage one or more of these specialized bodies of regulatory rules and personnel as well as the general set of rules. Although the possibility for this type of regulatory system is imaginable (in fact, almost palpable), its realization would require substantial diligence and a significant rethinking of current regulatory rules and structures. The costs of this level of diligence and rethinking may well exceed the potential benefits.

V. CONCLUSION

This essay both assumes and, in certain respects, illustrates that the U.S. system of financial regulation has become outdated in light of the increasing complexity and fluidity of financial and related interests and instruments—focusing especially on those classified as securities. In attempting to keep pace with this complexity and fluidity, the overall financial regulatory structure has become too complex to be effective—or even sustainable.

[T]he U.S. regulatory system needs to be simplified and moved away from a functional regulatory structure towards one that regulates based on the risks posed by the products, services, or firms. The complexity and costs of the current structure encouraged firms to seek ways to avoid it. These incentives have only been heightened with the new, more complex structure created by the Dodd-Frank Act.

In addition, the structure's very complexity was part of the reason that firms were able to engage in regulatory arbitrage in the first place. The structure is based on rigid definitions for banking, securities, and insurance products that allowed them to create hybrid products, services, or firms that failed to fit within those definitions. By minding the gaps in the U.S. regulatory structure, financial firms were able to take on excessive risks and create and sell questionable products and services.¹⁰⁷

Efficacious regulatory reform depends on a process that consists of more than the legislative and agency reactions to political imperatives that have characterized reform efforts to date. Successful reform will come from an assessment of the full range of financial and related interests, instruments and offerings to be regulated and the processing of this knowledge taking into account both theory and policy. Those of us with knowledge of securities and securities regulation must participate actively in the regulatory conversation, taking into account our unique knowledge of

¹⁰⁷ Brown, *supra* note 91, at 1414.

the financial instruments that may be classified as securities and their role in market transactions.

[T]wo primary challenges in regulating capital markets are, first, to identify risks within these markets and, second, to identify mechanisms that can lessen or manage those risks. Questions about how to allocate these mechanisms within a regulatory structure should be answered in light of policymakers' conclusions regarding *what* to regulate and *how* to regulate it.¹⁰⁸

To best engage an analysis that will contribute effectively to the broader conversation about an optimal system of financial regulation in the United States, we must first determine in a more rigorous and comprehensive way what a security is and then identify the different types of risks that securities and transactions in securities entail. The integration of this knowledge with similar knowledge from other areas of financial regulation—and from regulatory areas that govern financial and related interests not traditionally characterized as financial regulation (like consumer protection, charitable and other nonprofit solicitations and gambling)—will provide us with enough information to better parse and delineate the required or desired regulatory structures and identify the needed regulatory tools. The success of this venture, however, also depends on a well-articulated set of policy objectives—one more well-defined than we now have—and the development of, and attentiveness to, applicable theory. Although the ideas presented here are important new pieces of the puzzle, much work remains to be done.

¹⁰⁸ Omarova & Feibelman, *supra* note 90, at 883.

